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The Sequence in War Prosperity and Inflation

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PROSPERITY and depression, like most words in common use, are very elusive terms. The average university sophomore is fairly certain that he knows precisely what they mean, yet a little questioning soon reveals the fact that he is quite at a loss to give the words definite content or to state the fundamental criterion by which one may determine the one or the other. It becomes necessary, then, to brush aside some of the loose thinking and popular fallacies that prevail.

THE CYCLE OF PROSPERITY AND DEPRESSION

In the first place, industry is generally thought of as running along on a normally level course of prosperity, sooner or later, by accident as it were, to be plunged into the abyss of deep depression. Statistical investigation shows that such is not the case. On the contrary, industry continually rides a sea of undulating waves, now riding the upward waves of prosperity, now turning the crest of the crisis, now sailing the downward wave of depression, and finally trimming its sails in the trough of the wave in preparation for the next cycle. Neither prosperity nor depression are static conditions. They are dynamic phenomena always changing into something else. Prosperity inevitably develops into crisis, crisis into depression, depression into recovery, and recovery into prosperity.

Inflation and Prosperity

Another popular fallacy relating to prosperity and depression is that everyone is benefited by prosperity, and likewise everyone is adversely affected by depression. But society is made up of a great complex of industrial groups and classes, and the changes taking place in the industrial cycle by no means affect all alike. This is especially true when such profound changes take place in the cyclical movement of industry as have taken place in the war period under discussion. In fact, this opposition of interests has been so keenly felt during the last few years that it has served to obscure in the popular mind the meaning of the term prosperity. Has the war been a period of prosperity? Certainly not to the classes with fixed incomes, to the investing class or to the salaried class. It therefore turns out to be a considerable shock to many people to be told that a period of rising prices is uniformly a period of prosperity, and a period of falling prices a period of depression. To most people, at the present time, falling prices would appear a consummation devoutly to be wished, but they certainly do not think they want depression.

What they fail to realize is that the wheels of modern industry are controlled by the compelling power of profit making. Industry goes or stands still in accordance with the profit making advantage of the business

entrepreneur. Since modern industry is controlled by the entrepreneurial class, whatever period is profitable to them must necessarily be a period of great industrial activity and prosperity, regardless of how other classes may be affected.

Now a period of rising prices is always a period of profit making, and this is true particularly for the reason that in a period of rising prices the spread between costs and selling prices is widened. Wages and rents particularly lag behind selling prices, and thus the margin of profits is increased. The opportunity for profit making thus afforded stimulates production and industrial activity ensues. Thus the process of producing goods is subordinated to the process of making profits, and the prosperity of society is viewed through the spectacles of the profit receiving class.

The Enigma of Unemployment

Here we encounter the greatest enigma of modern industrial society, viz., the failure of the existing industrial organization, except in brief periods of the very greatest prosperity, to utilize to the full its productive power. Much is said about the scarcity of labor and the lack of industrial equipment, yet it is estimated by Secretary of Labor Wilson that there are from one to three million workmen who are employed or unemployed according to our position in the cycle of prosperity and depression. Another estimate¹ places the figures at from one to four and one-half million. Everyone is familiar with the spectacle of plants running at low percentage

capacity. The industrial cycle is an index of the extent to which we are utilizing to the full our productive power. In recent decades, probably, there have been only two periods in which we have measurably approached our full power to produce, the period of intense prosperity in 1906 and 1907 and the period of the recent war. The extent to which we normally fail to utilize our productive capacity becomes evident when we consider the increase of production that took place during the war despite the withdrawal of over 4,000,000 men into the service. The reliable data worked out by Wesley C. Mitchell² indicate that our physical production in the war years 1917 and 1918 exceeded our physical production in 1913 by 14 per cent and 16 per cent respectively. It has been estimated³ that this increase in production was sufficient to cover the cost of the war in tangible goods without reducing either our normal supply of capital equipment or the average standard of consumption.

The cycle of prosperity and depression is the record of industrial activity. In the modern industrial society this cycle is a continuous process which finds its expression in the movements of money, credit, prices, profits and production. An analysis is here presented of monthly data pertaining to the above mentioned movements for the years 1915-1919. The following series are included in the study:

1. Ratio of reserves of Federal Reserve Banks to net liabilities.

¹ Mitchell, *History of Prices During the War, Summary*, War Industries Board, Price Bulletin No. 1.

² Viner, "Who Paid for the War," *J. of Pol. Econ.*, January, 1920, p. 58.

¹ Hornell Hart, *Fluctuations in Unemployment in Cities of the United States, 1902 to 1917*, Helen S. Troustine Foundation, Cincinnati.

2. Total reserves of the Federal Reserve Banks.
3. Total deposits of the Federal Reserve Banks.
4. Federal Reserve notes in circulation.
5. Deposits of New York clearing house banks.
6. Loans of New York clearing house banks.
7. Money Rates on 4-6 months prime commercial paper.
8. Prices of twenty industrial stocks.
9. Prices of twenty copper stocks.
10. Industrial dividend payments.
11. Production of pig iron.
12. Production of copper.
13. Unfilled tonnage of U. S. Steel Corporation.
14. Exports.
15. Wholesale commodity prices.

The data pertaining to the Federal Reserve System were taken from the *Commercial and Financial Chronicle*, and the figures for the other series were obtained from *Babson's Desk Sheet of Tables and Charts*. The actual figures, with the exception of the ratio of reserves to liabilities, were in each case reduced to relative figures or index numbers for the purpose of comparison. The months of June and July, 1917, constitute the mid-point of the period under consideration, and the average of the figures for those two months has, in each series, been taken as the base. It will be noted that the first half of the period corresponds substantially to the period of American neutrality, and the last half is the period of American participation in the war.

MOVEMENTS OF THE MONEY MARKET

Prior to the establishment of the federal reserve system the surplus

reserves of the New York clearing house banks constituted the primary index of the condition of the money market. Since the establishment of the reserve system, the reserves of the member banks are replenished through the process of re-discounting at the federal reserve banks. Bank credit rests, therefore, ultimately on the reserves of the federal reserve banks and not on the reserves of the member banks.

Table I gives the index numbers worked out as explained above for money rates, total reserves of federal reserve banks, deposits of federal reserve banks, federal reserve notes, loans and deposits of the New York clearing house banks, and the actual per cent for the ratio of reserves to liabilities. Federal reserve notes do not begin to assume any large proportions until the middle of the period under consideration. The ratio of reserves to liabilities is limited to deposit liabilities for the months June to November, 1917, otherwise liabilities include federal reserve notes in circulation.

It will be noted that reserves expanded enormously during the greater part of the period. This was made possible by the huge importation of gold, amounting to a total of \$1,200,-000,000, during the period of American neutrality. The jump in reserves immediately following our entrance into the war resulted from the rapid impounding of gold into the federal reserve banks. Under ordinary conditions it is usually found that surplus reserves rise with an increase in reserves, and money rates, therefore, usually move in inverse ratio to reserves. In this case, it will be noted that money rates and reserves moved

TABLE I. MONEY MARKET CONDITIONS

(Index numbers, base June-July, 1917; actual percentages are given for the ratio of reserves to net liabilities.)

	Ratio of reserves to liabilities	Money rates	Reserves federal reserve banks	Deposits federal reserve banks	Notes federal reserve banks	Deposits New York banks	Loans New York banks
1915							
January	93.3	80.6	19.3	19.6		59.7	57.1
February	96.7	75.6	20.9	20.2		63.7	59.4
March	91.0	70.6	19.8	20.1		66.0	61.6
April	89.3	75.6	19.8	20.6		67.6	62.0
May	93.3	74.0	20.6	20.4		67.9	62.0
June	97.4	74.0	22.8	20.9		71.1	67.7
July	91.8	73.1	21.6	21.4		73.8	66.9
August	88.2	73.1	21.6	22.2		76.9	60.2
September	88.7	68.0	23.5	23.1		81.6	72.2
October	87.5	65.5	23.9	25.1		91.8	78.6
November	86.9	63.0	26.9	28.9		94.1	82.7
December	89.1	65.5	27.2	28.9		94.5	83.8
1916							
January	80.8	63.0	27.4	31.8		96.5	85.0
February	80.4	60.5	26.9	31.2		97.3	85.7
March	76.0	63.0	26.6	31.7		96.5	86.1
April	72.2	65.5	24.3	31.8		96.1	86.8
May	70.1	65.5	27.0	36.4		93.4	86.1
June	73.4	74.0	30.4	37.3		91.0	84.2
July	69.9	83.2	28.6	38.2		87.1	81.2
August	70.6	75.6	28.0	38.6		88.6	81.9
September	71.0	73.1	29.7	39.2		91.8	85.3
October	72.8	73.1	30.6	40.7		92.9	86.5
November	75.3	70.6	36.0	46.3		95.7	88.3
December	70.7	80.6	34.3	47.0		91.8	86.1
1917							
January	76.3	70.6	40.3	49.9		99.2	88.7
February	73.6	83.2	38.5	49.3		101.2	90.6
March	81.2	90.7	43.1	51.1		103.1	92.9
April	74.2	90.7	41.5	57.3		105.1	95.1
May	67.8	98.3	76.3	74.1		100.4	93.6
June	68.4	103.3	93.7	100.6	96.8	99.6	99.6
July	78.8	96.8	106.3	99.6	103.3	100.8	100.7
August	79.9	100.8	105.7	97.4	113.9	101.5	101.1
September	74.5	108.4	109.5	97.3	129.6	100.4	103.4
October	70.3	113.4	116.6	112.2	164.2	116.4	124.4
November	62.8	110.9	126.0	129.9	196.5	132.4	166.2
December	63.6	113.4	127.5	127.9	237.5	136.3	164.6
1918							
January	65.4	115.9	134.0	129.0	239.0	141.4	159.9
February	66.0	115.9	137.8	124.0	254.5	139.8	156.4
March	63.4	121.0	139.9	131.5	276.8	142.2	160.5
April	61.3	121.0	142.2	136.0	295.5	144.5	163.5
May	62.0	121.0	148.5	139.5	310.0	142.9	168.4
June	63.4	121.0	148.8	144.0	324.8	144.5	166.5
July	57.9	121.0	153.7	151.0	378.5	139.8	162.0
August	56.4	121.0	155.4	149.5	405.0	139.8	165.8
September	51.6	121.0	155.8	163.0	454.0	144.5	168.8
October	49.6	121.0	157.5	180.5	486.0	146.1	173.7
November	50.0	121.0	159.3	168.0	497.0	146.5	175.5
December	50.6	115.9	160.4	165.9	516.0	149.6	172.9

TABLE I. MONEY MARKET CONDITIONS—*Continued*

	Ratio of reserves to liabilities	Money rates	Reserves federal reserve banks	Deposits federal reserve banks	Notes federal reserve banks	Deposits New York banks	Loans New York banks
1919							
January.....	53.0	108.4	163.8	164.4	474.0	152.3	176.7
February.....	51.3	103.3	164.5	171.2	478.0	147.2	176.7
March.....	51.6	108.4	166.0	179.4	486.0	151.2	180.1
April.....	51.7	108.4	168.0	169.8	493.0	154.3	180.8
May.....	51.8	105.8	169.2	172.5	487.0	157.8	183.8
June.....	52.5	110.9	168.0	183.0	482.0	155.1	181.6
July.....	50.5	110.9	162.0	175.0	485.0	157.0	184.2
August.....	50.7	108.4	161.0	171.0	499.0	155.8	184.2
September.....	51.0	108.4	164.5	177.8	513.0	161.3	191.7
October.....	47.9	105.8	165.8	190.5	532.0	162.5	199.6
November.....	45.5	113.4	162.4	202.8	552.0	162.5	195.5
December.....	44.8	118.4	160.5	194.2	592.0	159.0	191.3

together, for, while reserves were mounting up, deposits and federal reserve note circulation were increasing at a still greater rate. This is indicated by the movement of the ratio of reserves to liabilities which progressively declined in spite of the expansion of reserves. Therefore, even though reserves rapidly accumulated, the money market became tighter and money rates became higher. Only during the year 1915 and the early part of 1916 did the ratio of reserves to liabilities run very high and money rates low. Beginning with the latter part of 1916 and extending to the close of 1918 the demands made upon the money market were so great that in spite of added reserves the ratio of reserves to net liabilities declined and money rates moved up. Further inflation of banking credit was measurably stopped by the close of 1918. The ratio of reserves to liabilities ran nearly uniform from September, 1918, to September, 1919, and for the first ten months of 1919 money rates ran correspondingly on a fairly level course. At the close of the year banking credit was still further strained and rates became higher.

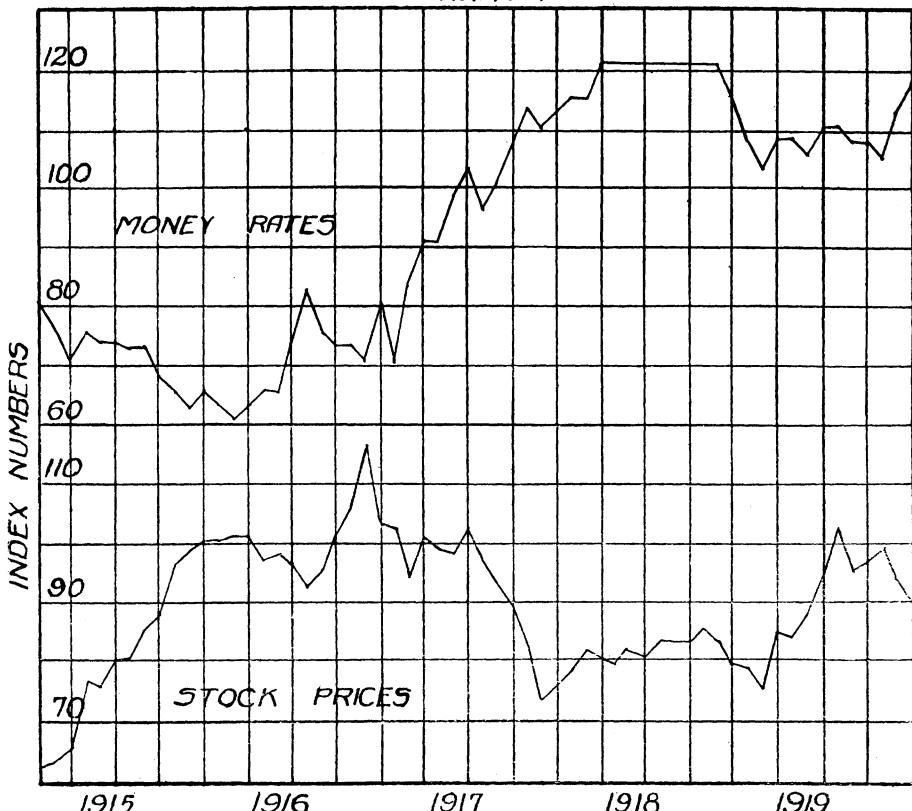
Money Rates, Stock Values and Profits

The relative movements of money rates and industrial stock prices are shown in Chart I. The index numbers for the industrial stock prices were constructed by averaging the prices of twenty industrial stocks and twenty copper stocks. The curves are placed in juxtaposition to bring out more clearly the inverse correlation. The two most fundamental factors affecting stock values are the current rates on the money market on the one hand and the trend of corporate profits on the other. Stock prices move in inverse ratio to the former and in direct ratio to the latter as appears in Chart II, since production may safely be accepted as a reasonably accurate index of the trend of profits. The production index numbers are the simple arithmetic average of production of pig iron, production of copper, unfilled tonnage of the U. S. Steel Corporation, and exports. It is an index, therefore, of the production of war materials rather than of production in general. General production of course did not increase in any such proportions. A comparison was made

of the production index with industrial dividend payments averaged quarterly as a further evidence of the trend of profits. Production reached the trough of the wave in December, 1914, and rapidly rose during 1915 in response to the war demand of the allies. The period of maximum production of war

The two charts then indicate the relation between stock prices and money rates on the one hand, and production and profits on the other. Assuming profits as constant, stock prices would fluctuate inversely with the movement of money rates. Assuming money rates as constant, stock

CHART I.



materials was during 1916 and the first half of 1917, the peak being reached toward the end of the period of American neutrality. With the readjustments incident to the entrance of the United States into the war and the consequent withdrawal of men from industry, production declined somewhat, but rose again during 1918. The last year brought a heavy decline,

values would fluctuate directly with the movements of profits. The influence of both factors are apparent in the trend of stock prices and, on the whole, tend to reinforce each other.

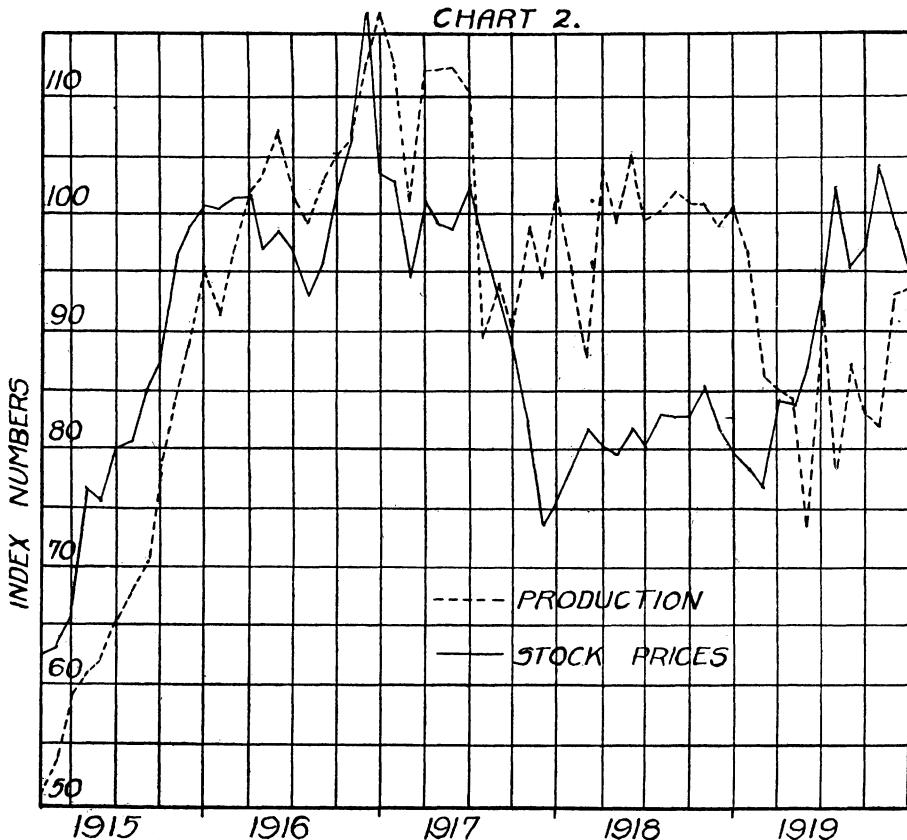
INFLATION AND PRICES

The remarkable expansion of production occasioned by the European demand for our goods brought with it

inflation of bank credit. The Europeans paid for our goods, mainly, in two ways: (1) by sending us gold and (2) by selling us securities. This enormous importation of gold resulted in a surplus of reserves and forced a decline in the rate of discount during

inevitable result was a general rise in prices.

Chart III shows the curves for inflation of bank credit and for commodity prices at wholesale. The credit inflation index is a simple average of the deposits and loans of the New York



the year 1915. The banks were in a position to generously extend loans, the war industries rapidly expanding needed funds, and the purchased securities were at hand to serve as convenient and adequate collateral. Thus the European war trade furnished not only the stimulus for increased production but also the means for rapid inflation of bank credit. The

clearing house banks. This average has been used in preference to the credit expansion of the federal reserve system because of the fact that the reserve system practically started from nothing at the beginning of our period, and, therefore, the relative expansion that took place in that system was out of all proportion to the general expansion of credit in the country as a

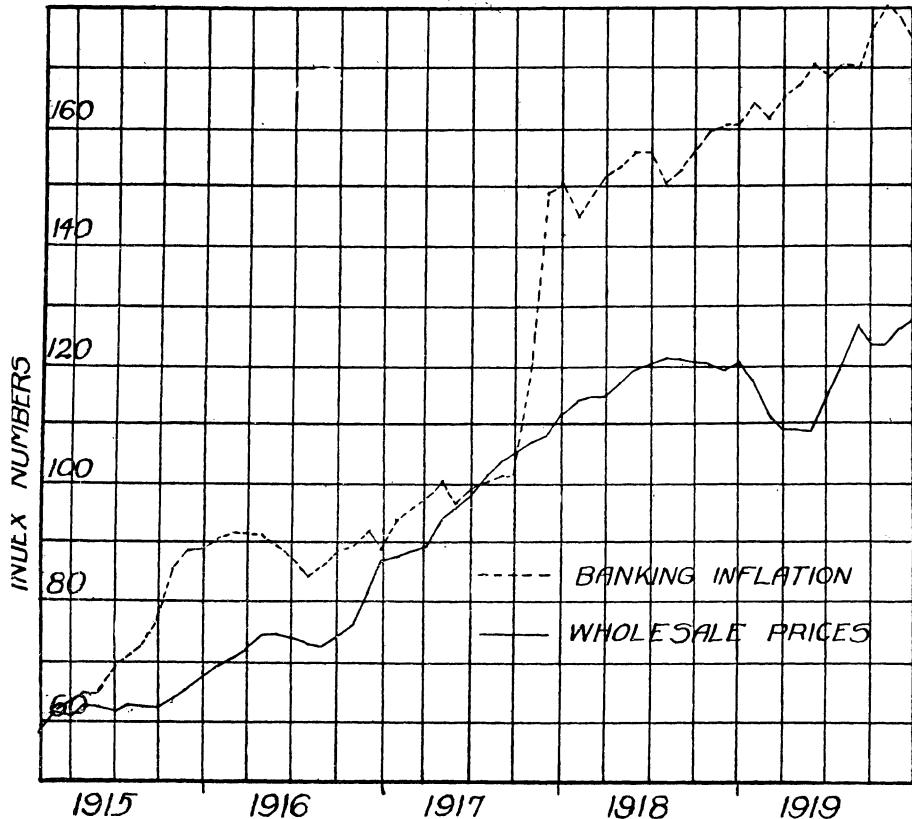
whole. The price index is Bradstreet's index of wholesale prices.

Inflation and Shortage of Goods

The opinion appears to be held quite generally that the recent enormous advance in prices is the result of a

index of physical production, Viner estimates⁴ that the aggregate increase in production from January, 1917, to May, 1919, was 10.8 billions of dollars in terms of 1913 prices. The total estimated cost of the war for the corresponding period in terms of

CHART 3.



shortage of goods occasioned by the war. If Mitchell's estimate of the increase in physical production during the war is correct it appears that after subtracting the war materials consumed by the United States, as well as the excess of materials sold to our allies, the physical product or supply of goods remaining is little if any lower than before the war. Using Mitchell's

1913 prices he finds to be 10.4 billions of dollars. If this estimate is reasonably correct, no shortage of goods occurred in the United States because of the war.

It may still be argued, however, that the enormous excess exports of the period 1915-1919 must have resulted in a shortage of goods. Following is an

⁴ Viner, *J. of Pol. Econ.*, Jan. 1920, p. 58.

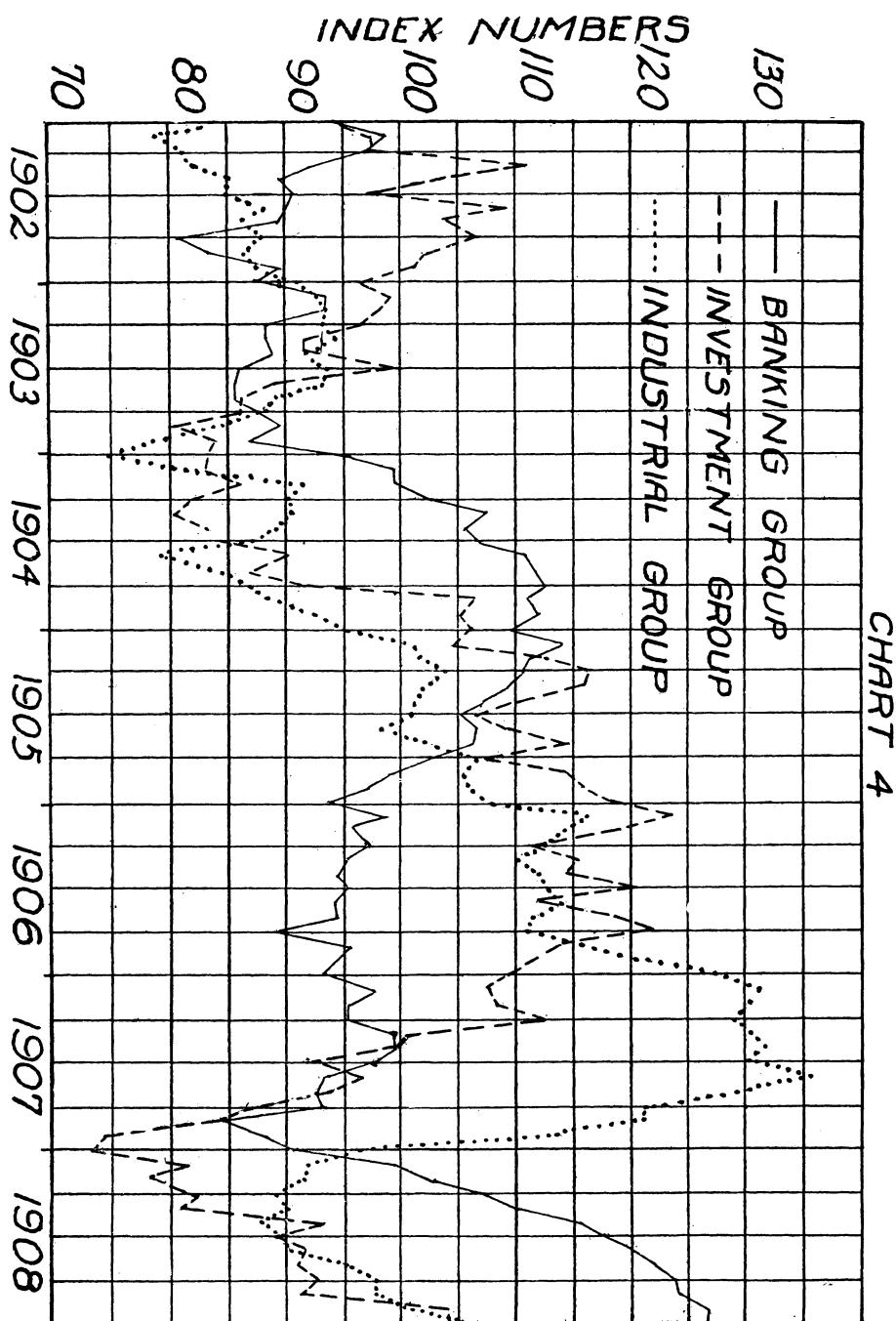
estimate of the value of our excess exports in terms of 1913 prices, using the wholesale price index of the Bureau of Labor Statistics as the means of conversion to the 1913 basis.

Year	Exports on basis of 1913 prices in billions of dollars	Excess war exports on basis of 1913 prices in billions of dollars
1913	2.5	
1915	3.6	1.1
1916	4.4	1.9
1917	3.5	1.0
1918	3.1	0.6
1919	3.7	1.2

The total excess war exports was therefore 5.8 billions in terms of 1913 prices. But the excess production of 1915 and 1916, viz., 7 per cent and 11 per cent respectively according to Mitchell, more than equals this amount. On the basis of 1913 prices the excess production for these two years would be 6.2 billions of dollars. If, then, these estimates are at all reliable the extraordinary production of the war years fully compensates for the supposed shortage of goods arising out of exports as well as our own consumption of war materials. The rise in prices cannot then be explained on the basis of shortage of goods. It can only be accounted for on the basis of inflation of currency and credit. The importation of over a billion dollars of gold, and the credit creating capacity of the federal reserve system made enormous inflation inevitable in the absence of rigid governmental regulation. Thus prices rose with the volume of currency and bank credit.

THE NORMAL SEQUENCE IN THE BUSINESS CYCLE

The normal sequence of the banking, investment and industrial movements of the business cycle are completely upset by the unusual conditions arising out of the war. Normally, as found in a study made by the writer of monthly data from 1902 to 1908 inclusive, the sequence runs as follows: Depression brings on a reduction of outstanding bank credit and a return of money from hand to hand circulation, following the decline in prices. The resulting accumulation of reserves is the essential feature of the period of recovery. Bankers progressively lower the rate of discount to a point low enough to make the employment of bank credit again profitable. Bank loans are readily obtained, new securities are freely issued, and the purchasing power of business enterprises increases. The cycle is moving upward. The increased demand which results from the expansion of bank credit soon shows itself in a rising stock market, greater production, larger volume of imports, more general employment of labor, increased immigration and rising prices. Rising prices and the increased volume of production result in increased earnings and profits. The demand for bank credit continues to be strong while prices are rising. But rising prices result in more money being drawn out into hand to hand circulation. There follows, therefore, an actual diminution of reserves at the very time when bank credit is being extended. It therefore becomes necessary not merely to stop the expansion of bank credit, but actually to reduce the outstanding volume. The demand for bank credit is not lacking but the



supply is strained to the limit of safety. The banks protect themselves by raising the discount rate and by scrutinizing more carefully the solvency of borrowing firms. A gradual reduction in outstanding bank credit is forced. This movement results in the forced sale of securities because of the inability on the part of borrowers to renew their loans. The stock market begins to decline, trading on the stock exchange is reduced and bank clearings fall off. New securities are issued with difficulty, and this, coupled with the inability to obtain loans readily at the banks, reduces the purchasing power of business enterprises. Presently, building falls off; then production, imports and commodity prices. Thus the limitation on the volume of bank credit gradually drags down stock prices, shares traded, bank clearings, building, employment, imports, prices, profits and production. When the diminution in profits appears, the downward movement is further accelerated by the letting up in the demand for bank credit. Thus the downward movement, like the upward movement, tends to become self-perpetuating.

But as the upward movement culminates because of the strain placed upon bank reserves through an undue extension of bank credit, so the downward movement brings on recovery because of the rapid accumulation of reserves due to the reduction of bank credit and the return of money from hand to hand circulation consequent upon falling prices. Thus the cycle develops inevitably from one phase into another.

The above analysis finds verification in Chart IV. Seasonal fluctuations have been eliminated in these curves.

The curve labelled Banking Group is a weighted average of reserves of New York clearing house banks, deposits of New York clearing house banks, loans of New York clearing house banks, call loan rates (inverted), and rates on prime commercial paper (inverted). The curve labelled Investment Group is a weighted average of the prices of ten investment stocks, the prices of forty transportation stocks, shares traded on the New York stock exchange, total bank clearings, and liabilities of business failures (inverted). The curve labelled Industrial Group is a weighted average of wholesale prices, production of pig iron, railroad gross earnings and imports.

The general movements may be followed by reference to the chart. Since the separate individual movements do not appear the following brief statement is given. The first movement appeared in bank reserves, loans, deposits and discount rates. Reserves began to accumulate late in 1903. With the upward swing of reserves there followed an extension of loans and deposits. The extension of bank credit increased the demand for securities. The stock and bond market began to rise in the early part of 1904. The average for the investment group started upward in March. Building began to increase in May, commodity prices in July, imports and railroad gross earnings in August, and the production of pig iron in September. The average for the industrial group started upward in August. Thus the upward swing of reserves, and the expansion of loans and bank credit, consequent upon the easing up of the rate of discount, pulled up one

by one stock values, prices, profits, and production.

The downward movement again began with reserves, deposits, loans and discount rates. The reduction of bank credit affected the security market and stock prices began to drop. The average for the investment group began to move downward in the early part of 1906. Industrial activity still continued to increase for a time, but gradually the inability to obtain bank credit readily or float new securities had its effect. Building began to decline in May, 1907, and the average for the production of pig iron, imports, commodity prices and railroad gross earnings began to fall in July.

Similar facts appear in the upward movement following the depression. The banking group started upward at the close of 1907. Stock prices followed in the early months of 1908. The average for the investment group began to rise in January, 1908. Building increased in March and the average for the industrial group started on the upward movement in June.

Here the interplay of banking, investment and industrial forces are working themselves out without external governmental interference. Industrial activity is held in check or speeded up according to the business possibilities of profit making. Only in the period of rising prices is the ability to sell at a profit equal to the productive capacity of society. Production rises and falls with prices, and prices in turn rise and fall with the ebb and flow of the money market.

What is the reason for this ebb and flow? Banking institutions alone, excepting the government, have the power to create money or its substi-

tutes, *i.e.*, to issue notes or create demand deposits. In other words, banks manufacture purchasing power. But the supply of this bank product in no way depends upon the multiplication of banks. The possible expansion of bank credit is restricted, within somewhat flexible limits it is true, by the physical volume of gold reserves in the nation and ultimately in the world. The supply of bank credit is in no way dependent upon the cost of banking, and only slightly upon the cost of production of gold since the annual production of gold is very small compared to the total supply. Therefore, banks place no "reservation prices" upon bank credit. They will sell it for whatever they can get. The price depends purely upon the demand. When loans are being reduced and reserves accumulate banks must reduce the price (rate of interest) in order to dispose of all their wares (bank credit). The reduced price of bank credit again makes production profitable. Loans are called for, securities are issued, the purchasing power of business is increased, prices rise. Selling prices rise sooner and faster than cost prices and profits are increased. The upward movement of prices for the time being releases the pressure of production on profit making. Prosperity is in full swing and continues to be until bank credit has expanded to its limit and a halt is called to the rising movement of prices. Profits decline and bank loans are reduced until a fresh accumulation of reserves starts another cycle. It is as though you threw a ball to which is attached a rubber band. The rubber band pulls back the ball with the same force with which it is thrown. And were it not

for the force of gravitation the ball would continue to bound and rebound.

The War Sequence

Thus under normal conditions, when the motive of profit making controls industrial activity, productive capacity is utilized to the full only in the period of inflation of bank credit and rising prices, and this inflation inevitably finds its termination in the limitation of bank reserves. But the war introduced a new factor in production and inflation. It was no longer wholly a question of reserves or profit making. It was a question of national need. Hence the war sequence did not run from reserves to loans, deposits, issue of securities, and thence to prices, profits and production. Purchasing power was no longer limited by the physical volume of reserves. Government credit entered the field directly in the form of paper money in many countries, and everywhere indirectly through taxation and the issue of

treasury notes and bonds. Reserves were no longer the limit of prosperity and inflation. The limit was the sky, and for proof witness the paper inflation in Europe.

The inflation arising from the war need might, no doubt, have been restricted to a considerable extent by a greater resort to taxation with less reliance on bond issues as a means of financing the war, or by the selective conscription of labor and capital for war production. But either method would have had a tendency to reduce production. The taxation method, by compelling greater economy, would have reduced the demand for goods non-essential for war purposes. And the industrial conscription method would, by compulsion, have reduced the quantity of production of such goods. In short, the greatly increased production of the war period would have been impossible without considerable inflation.